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Aspects of A Flat Rate Tax

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NOTA

El Dr. Fritz Neumark ha participado en varias ocasiones anteriores en el programa de profesores visitantes del Departamento de Economía. El 24 de abril de 1984, presentó una ponencia sobre la Tasa Contributiva Fija ("Flat Rate Tax"), cuyo contenido presentamos como parte de la Serie de Conferencias y Foros de la Unidad de Investigaciones Económicas.

En su disertación, el Doctor Neumark sostiene que es necesario disminuir la progresividad del sistema contributivo actual al igual que las altas tasas contributivas. Sugiere, además, que se adopte como alternativa una versión modificada del sistema de la tasa contributiva fija. Esta, en su opinión, es la solución a los problemas de la evasión contributiva y la proliferación de actividades económicas subterráneas, consecuencias directas de las actuales altas tasas contributivas progresivas.

De seguirse las directrices sugeridas en la ponencia del Doctor Neumark, la tasa contributiva fija disminuiría el diferencial existente entre la incidencia fiscal promedio y marginal resultando a su vez en una medida anti-inflacionaria y de estabilización económica que estimularía el trabajo, el ahorro y la inversión.

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Aspects of a Flat Rate Tax

by

Dr. Fritz Neumark

Whenever a country finds itself in a critical state, people always come up with cure-all prescriptions which they claim are new. Most of the time they are not new at all, but can be traced to earlier decades or even centuries, albeit under different economic, social, and political circumstances. When these prescriptions do not yield the expected cure, the allegedly new doctrines fall into oblivion until they reappear at a future date under a different name. All this is proof of the cyclical nature of economic and fiscal theories.

Let me mention two examples. Mercantilism was thought to have become unfashionable in the reign of a liberal market economy, but some time ago it has been resurrected by such outstanding economists like Joan Robinson in her inaugural lecture at Cambridge, England. A more recent example is the so-called Laffer curve, much debated only a few years ago, but almost totally discarded today. The gist of the theory behind this curve had already been put forth in the 13th century by authors like Jonathan Swift and Adam Smith. I should add that Swift and Smith confined their arguments to customs and excise duties, whereas Laffer argued in favor of reduction in the income tax which he expected would increase the revenues from this tax.

It is not impossible, although not very probable, that at least the radical form of the flat rate tax will share the same fate as the Laffer curve. For, those who favor such a tax neglect several points. First, they do not give sufficient attention to the fact that the present opposition to

the income tax has developed only after the original proportionality of the tax, which did not permit even indirect progressivity, was replaced by steeply progressive rates so that its overall burden was increased to a considerable degree. Second, they also forget that a modern tax system consists not only of the income tax, but of several other elements which also have graduated rate schedules. The most striking example is the net value added tax which in many countries is levied with differentiated rates, which give it a certain degree of progressivity or reduce its alleged regressivity. I would like to add that such taxes give rise to tax evasion and avoidance in about the same way as a progressive income tax. This is particularly observed in Italy, but also in France and Germany. One of the top experts in the field, Soubren Knossen, rightly points out that "exemptions and differentiated rate structures inevitably discriminate on the basis of relative preferences". A similar criticism has been made by Henry Aaron in a Brookings publication on the experience of European countries with the value added tax.

In principle, one can conceive of tax systems with very different structures. For one, taxes are levied at different levels of government - central, state, and local. Moreover, in addition to taxes proper, the total fiscal burden includes other public revenues such as fees and above all contributions to social security systems. As a result, because of the differences in its elements, the burden of the total tax system may be distributed in such a way that the final outcome may be one of more or less proportionality, or of progressivity, or of regressivity. Leaving aside the complex questions connected with the shifting and incidence of taxes, let us assume that the incidence of the total tax system is proportional.

Evidently, even then there must be a progressive income tax if only to neutralize the regressive effects of indirect taxation - the more so, the higher the relative importance of indirect taxation in the tax system.

We have to admit that we do not know exactly what the final outcome of overall taxation really is. It is my opinion that in most developed countries it is one of at least some progressivity. This fact is mainly due to the enormous increase in income taxation. Indeed, when most excise duties have a revenue elasticity of less than one, and the value added tax an elasticity of just about one, the elasticity of the income taxes on wages and salaries is between 1.5 and 2.0. It is to be noted that income taxes on wages and salaries amounted to about 35% of total income taxation (including the corporation income tax) in Germany in 1961. Today they exceed two-thirds. That in the United States the share of income taxation in total tax revenue is somewhat lower than in Germany or Sweden, for instance, is due to the fact that there is no value added taxation in the United States as yet. However, even in the United States income taxation, which in 1961 yielded less than 7% of the tax total, today amounts to 23%.

The more than proportionate increase in the income tax yield is due above all to the following factors: First, the rise in nominal incomes as a consequence of economic growth. Second, the insufficient adjustment of incomes to the effects of inflation. Third, the increase in the tax rates and in average progressivity. At any rate, today the backbone of income taxation is represented by what is called the wage tax, i.e. that part of the general income tax which is levied on wages and salaries. Workers and employees who in 1965 had to pay a marginal tax rate of slightly above 22% now pay 43-44% at the margin. And if one were to include the social security

contributions, the "psychological breaking point" of 50% is exceeded by the great majority of skilled workers. As a result, the disposable income of wage earners has diminished from 58% of the gross income to 53% or less during the last two years. All these figures relate to the experience in Germany.

The progressive character of the tax, particularly in times of high inflation, has marked anti-incentive effects to work, to save, and to invest. Moreover, there is a close inter-relationship between high tax rates, steep progressivity, and the level of tax transparency. For, the steady rise in the marginal tax rates has led governments and parliaments to legislate more deductions, exemptions, and allowances. As a result, tax transparency has decreased; but greater injustice was also incurred, since most loopholes can be used fully only at the upper income levels with the assistance of tax consultants.

I would like to raise one other point which I believe to be extremely important in the expansion of the public sector. Because of the rising built-in-flexibility and consequently of the almost automatically rising tax revenue, governments and congresses were induced to vote for higher expenditures. It is my confirmed belief that modern income taxation is in fact one of the most important reasons for the ever increasing size of the budgets.

Finally, I should like to add that in addition to giving rise to legal loopholes, high income tax rates have encouraged the taxpayers, particularly those in the higher income brackets, but of late also a great number of workers, to engage in underground activities and thereby escape the network of the fisc.

All of these undesirable aspects of the modern income taxation, especially those of steep progressivity, were no doubt among the main motives of the recent movements in favor of the flat rate tax. Those who favor such a tax are convinced that in order to avoid or at least reduce the anti-incentive effects, as well as the injustice inherent in the present legislation, the income tax should be reduced and simplified at the same time. The pursuit of these objectives seems to require that progressive rates be abolished and replaced with a flat rate; but it is still an open question whether at the same time one should also abolish the indirect progressivity resulting from exemptions, allowances, and deductions.

I have great doubt whether, even if such a reform were to be feasible politically, it would do away with tax evasion and cause the underground economy to disappear. Indeed, once taxpayers get accustomed to paying less in taxes than they legally should, it is not probable that a flat rate tax would make them to totally give up the practice of underreporting their incomes. Further, one must assume that even a flat rate tax contains some progressivity, albeit indirect, that results from personal allowances, which are left in the legislation. However, it would not be wrong to presume that with such a reform the difference between the average and the marginal tax burden will become sensibly less which should, in principle, encourage work, savings, and investment.

One should also not forget that the tax revenue and burden depend not only on tax rates, but to a very high degree on the width of the tax base. That is why many who favor the flat rate tax propose that the level and progressivity of the tax rate be reduced simultaneously with the abolishment of as many loopholes as possible. If the top rate of an income tax exceeds

a limit of 50% or so, powerful pressure groups will force the parliament and the government to admit numerous tax favors to a much larger extent than if there were only a unique rate of about 20-25%.

I firmly believe that the level and the degree of progressivity of the income tax should definitely be reduced. But also I would like to stress that a series of arguments proferred since the beginning of the last century against any kind of income taxation are bound to continue to play an important role in the struggle for tax reform. For example, the resistance in France until 1914 against any kind of income tax was largely based upon the idea that such a tax would be what the French called "fiscal inquisition" which, as such, was considered contrary to liberal principles of post-revolutionary France. And in the middle of the last century there were some British economists who considered even moderate progressivity as "a mild form of robbery".

Now, the idea of progressive taxation can be based on different considerations. First is the fisc's desire to obtain additional revenue. In this respect one should not forget that the distribution of income even in rich, fully developed countries is such that the absolute and relative budgetary importance of the highest income subject to the highest marginal tax rates is rather small and tends to become the smaller, the greater the overall economic growth. However, one should not forget that the effective tax burden of the high and very high incomes is considerably eased by a variety of loopholes. It is also wrong to compare a low flat rate tax with a steeply differentiated income tax, since the latter contains elements in addition to the tax rates which determine the final effective tax burden.

Second, although progressivity can be criticized on various grounds, its fundamental desirability is acknowledged on grounds of ability to pay.

I admit, there are no scientific and universally accepted criteria in constructing a specific progressive scale; the least one can hope for is the avoidance of the inequities and other deficiencies of the existing rate scales, particularly the inconsistency of their structure.

Third, to the extent that one accepts that one of the objectives of progressive income taxation is the redistribution of incomes and consequently of net wealth too, I believe that there are more effective alternative methods to achieve this objective, especially on the expenditure side of the budget.

Even if one recognizes that at least part of the criticisms is justified, I agree with authors like Philip Taylor that "...the choice between proportional and progressive taxation is ... a choice between certain injustice and uncertain justice". Further, the principle of taxation according to ability to pay requires that a more or less proportionate tax system which contains elements of regressivity in some of its components must compensate for the deficiency by containing progressivity in the other elements. At present there is no tax system which does not comprise a relatively large number of excise duties or a general consumption tax of the value added type. Hence, the task of constructing an overall proportionality in the system must require that it contain some direct taxes with differentiated rates.

The battle against modern income taxation and for a flat rate tax must also not overlook the fact that the principle of universality of taxation, if interpreted correctly, means that individuals with incomes below the minimum subsistence level should be exempt. One could even come up with strong arguments in favor of negative taxes in this respect. And finally, one has to admit - a point made by the well-known Italian economist De Viti de Marco long time ago - that in reality graduated tax rates always are

the result of a struggle for power between social classes, particularly of course between the rich and the poor.

Another much discussed point relates to the sensitivity of taxpayers to different kinds of taxes. It is the contention of some theorists that income taxation generally is bad, since it implies a high degree of sensitivity, whereas indirect levies are preferable since they are not perceived by the taxpayers. Therefore, from the point of view of repercussions on incentives to work, save, and invest, income taxes, especially if highly progressive, impair economic growth more than excise duties or the value added tax. In my opinion the sensitivity to taxes is not a bad thing; in fact it is rather good from a political point of view. In democratic regimes it is indispensable that people know why they have to pay taxes of a certain kind and amount. To conceal knowledge on the level of taxes or the public expenditures to be financed out of their revenue is anti-democratic. As against the assumed advantages of indirect levies implying a low or zero degree of sensitivity, most direct taxes, and particularly the income tax, provide the knowledge of what the individual himself has to pay and what others in equal positions must pay.

This is true only if taxes are transparent. Now, since transparency is largely impaired by progressivity itself and still more by its consequences in the form of numerous deductions, allowances, and special regimes, a flat rate tax would appear to be preferable indeed. But inasmuch as some partisans of a flat rate tax try to compensate the tax revenue loss by a simultaneous increase in indirect taxes, the taxpayer is so-to-speak duped by the fisc, since in most cases he does not know even approximately the amount of tax included in indirectly taxed goods and services. Moreover, most taxpayers

are unable to discern which part of a price increase is due to inflation and which part to an increase in tax rates, especially if the latter have been left unchanged for some time.

Perhaps, the most important point in the discussion is the fact already mentioned of the close relationship between high income tax rates, steep progressivity, and the erosion of the tax base. This gives rise to economic and social distortions which is admitted even by those who are not in favor of the flat rate tax. Hence, it appears that a flat rate tax does have important advantages in comparison with the present system of income taxation. This remark, however, calls for qualifications, to which I now turn.

Since a certain amount of tax revenue needs to be raised for a sound financing of given amount of public expenditure, the issue of the distribution of this sum among the taxpayers according to their ability to pay raises the necessity to levy taxes with a certain degree of progressivity. This is separate from and in addition to the function of the income tax to neutralize the regressivity in the other elements of the tax system. In fact, most criticisms against the current income tax systems are directed less against progressivity as such as against its exaggeration, particularly in the top rates. Moreover, real economic growth during and partly since the last war has proved that even high income tax rates and steep progressivity are not always incompatible with rather high rates of economic growth. The general question is whether a reduction in the income tax alone will bring about an increase in general economic growth. No doubt, high tax rates have negative effects, but today many economists in the government and outside tend to overrate both the positive and the negative effects of taxation on economic growth and to overlook or underestimate the adverse consequences of fiscal dirigisme.

Now let us look at some concrete flat rate tax proposals. There are many differences between them. As far as I know, nobody proposes a 100% proportionality, i.e. an income tax with one single rate with no personal exemptions and allowances which would give rise to some progressivity, albeit indirect. Indeed, today it is inconceivable that one should and could abolish the minimum exemption allowance or its differentiation according to family circumstances. The majority of those who favor the flat rate tax would like a drastic reduction in the number of brackets and rates together with a decrease in the marginal rates. All this requires compensatory measures, since the resulting tax loss would not be acceptable for the treasuries. What kind of measures could be envisaged?

The most radical measure would be the abolishment of all types of tax favors, exemptions and other exclusions which in the past have been motivated by the exaggeratedly high rate levels. Can this objective be achieved and how?

Economists like J. Pechman, who on principle are in favor of a progressive income tax, have tried to estimate the probable increase in revenue resulting from the near to complete abolishment of loopholes and shelters. But even then a certain increase of the initial tax rate has been found to be inevitable. Now, the difficulty with most current flat rate tax proposals is that the initial rate, especially if the tax has one single rate, has to be much higher for low income recipients than it is today. In any case, Pechman and others affirm and maintain that all the proposals under discussion imply a significant change in the tax burden distribution in favor of the rich and the very rich. This is the exact opposite of the intention of a graduated rate structure.

Such a change in the present tax burden distribution is not feasible in our political system. This is acknowledged by most partisans of the flat rate tax; who, however, are of the opinion that the poor would benefit from the general increase in economic growth to such an extent that even they would be left with a net benefit. This argument surely cannot hold; the transformation envisaged by the flat rate tax proposals certainly changes the absolute amount of the after-tax incomes much more in favor of the rich than the poor, and consequently impairs the relative situation of the latter. Therefore, overall social welfare, as measured by the distribution of after-tax incomes, will diminish.

The relevant literature also neglects one other critical point with respect to the flat rate tax. This relates to built-in-flexibility. Now, built-in-flexibility rightly can be considered an important positive factor in stabilization policy, but only under certain conditions. The degree of its stabilizing effect depends, among others, on the degree of progressivity. But the most important point is that the necessary conditions for its success as a stabilization measure have not been allowed to materialize during the last 15 years. One such condition is that part of the revenue increase due to built-in-flexibility should be used as a neutralizing factor. This can be done by using the funds to repay debt and, therefore, reduce the size of the public debt, or by depositing the funds in a "debt account" with the central bank to prevent the money supply from rising.

Instead, however, governments and parliaments have used the additional revenue even in times of prosperity, to expand public expenditures or to reduce the tax rates and have not deferred its use to future recessionary conditions. The result has been destabilizing and higher inflationary

pressure. What was maintained in many textbooks of public finance, namely that the essential difference between the private and the public sector was that in the former revenue determined expenditure, while in the latter expenditure determined revenue, was reversed. For, to a large extent public revenue came to determine the magnitude of the public expenditure. This was particularly true when revenue growth resulted not from discretionary measures, but from automatically operating built-in-flexibility.

Obviously, governments are incapable of designing a rational fiscal policy. As long as individual interest groups are stronger and more vociferous than the defenders of a policy pursuing the commonweal, the assumed advantages of built-in-flexibility will practically be non-existent. Progressivity as a stabilizing factor thus becomes almost negligible. This too makes for an argument in favor of the flat rate tax.

To sum up: Although in general I do not much favor compromises in economic theory, under the circumstances a well-balanced compromise seems appropriate or even unavoidable. Now, a radical one-rate flat rate tax is neither desirable nor politically feasible, even if some degree of indirect progressivity were to be incorporated into it. Therefore, what remains is a somewhat modified version with a sharp reduction of the number of rates -to three, at most four brackets - combined with a sensible diminution of the effective tax burden. This can be done by setting the initial rate at around 15-20% and the top rate at no more than 50%, with the average tax burden not being allowed to exceed 40%.

Simultaneously, however, loopholes and numerous tax favors should be abolished to the maximum which is politically feasible, and the assessment, collection, and auditing techniques be made more efficient. Withholding

should apply wherever possible. Should all this prove to be insufficient to meet the short-term revenue loss resulting from the reduction of the tax rates, one should by no means increase the indirect levies to make up the difference, as some ministers have recommended. Rather, public expenditures should be reduced, at least relatively. Finally, there should also be legal guarantees, perhaps even constitutional ones, to prevent the state and/or local authorities from altering their own levies in ways that counter the spirit and objectives of the federal tax reforms.

This is not too radical a reform. I admit, present parliaments and congresses will not easily adopt it. In case they do, I strongly recommend that it be enacted in its entirety in one single law, and not in parts stretched over several legislation. However, the implementation itself of the reform must be made gradually, say over a period of 4-5 years.

I would like to conclude by stating that personally, I am totally convinced that the income tax will have to be with us for a long time to come yet, but it must undergo, to quote Alan T. Peacock, a "major surgery". Of what kind is, e.g., demonstrated by Prof. Carl S. Shoup in his 1982 article on "The United States Economic Recovery and Tax Act of 1981" (British Tax Review, No. 5), from which I quote the last two sentences: "The greatest potential enemy of the income tax is public resentment and then contempt. The United States Federal income tax probably cannot stand more ERTAs without degenerating into a tax of poor compliance and expensive enforcement".

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